DELAWARE CHANCERY COURT CAUTIONS DIRECTORS ABOUT PERSONAL LIABILITY

DISNEY DECISION PROVIDES ROADMAP TOWARD MORE DIRECTOR ACCOUNTABILITY BY FOCUSING ON "GOOD FAITH" CONDUCT

The recent ruling of Chancellor William B. Chandler III of the Delaware Court of Chancery in *In re Walt Disney Co. Derivative Litigation* discussed but left unresolved the parameters of the so-called fiduciary duty of "good faith" -- a fiduciary duty potentially separate and apart from the traditional fiduciary duties of "care" and "loyalty" and a duty of paramount importance for a director's personal liability. The potential existence of a separate duty of "good faith" or, indeed, the superimposition of a "good faith" standard upon existing fiduciary duties, is not just a semantic issue; under the charter of most Delaware corporations, directors can be found personally liable for breaching their duty of loyalty, but they are exculpated from liability for breaches of their duty of care, even if that breach occurred as a result of gross negligence. *However, conduct that is lacking in "good faith" is not exculpable and may be the functional equivalent of a breach of the duty of loyalty for purposes of finding directors personally liable (and subject to money damages) for their conduct*.

- The Court determined that the "intentional dereliction of duty" is an appropriate standard for determining whether a fiduciary has acted in good faith. However, the Court explicitly noted that this is *not the only standard* and left open the question of whether motive is a necessary element for a successful claim that a fiduciary has not acted in good faith and, if so, whether that motive must be shown explicitly or whether it can be inferred from a director's conduct.

- The Court stated that a Board of Directors must consider carefully the process it undertakes in making a decision, not only with respect to issues involving directorial conflicts of interest (that is, duty of loyalty issues) but also in the degree of attention and diligence the Board devotes to the decision-making process in light of the materiality of the decision at hand (that is, duty of care issues); *a court may find the absence of an adequate process indicative of a lack of good faith.*

- The Court held that the Disney directors did not breach their fiduciary duties. Significantly, the potential future application by courts of the good faith standard (unless further modified by the Chancery Court or the Delaware Supreme Court) *should cause every director of a company to strive to meet high standards of corporate governance* since how a director makes a decision, including the Board's process and motives, could directly impact a director's personal liability.

- Each director should understand that his or her conduct will be examined individually, rather than being scrutinized together with all the directors as a whole.

The Duty of Good Faith

In the Disney opinion, Chancellor Chandler discusses the evolving concept of the duty of good faith, confirming his view that the "intentional dereliction of duty, a conscious disregard for one's responsibilities is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." The Court does not go so far as to explicitly state that there is a separate and distinct fiduciary duty of good faith. Chancellor Chandler indicates that the duty of good faith may encompass more than just the duties of care and loyalty, including within its scope "all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."

While Chancellor Chandler does not specify the precise nature of the obligation of directors to act in good faith, the source of the duty may not be important since "so long as the role of good faith is understood, it makes no difference whether the words 'fiduciary duty of' are placed in front of 'good faith,' because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable because they are disloyal to the corporation." The Court's observation emphasizes an underlying concern that exculpation for duty of care violations has left shareholders unprotected for any actions of directors that fall short of breaches of the duty of loyalty. Indeed, duty of care violations are rarely found; such conduct is only actionable if the director's conduct is grossly negligent and, even if a violation is proven, there is usually no economic consequence because the vast majority of Delaware corporations include a provision in their certificates of incorporation exculpating directors for breaches of the fiduciary duty of care (as permitted by Section 102(b)(7) of the Delaware General Corporation Law ("DGCL")). Exculpation however is not available where a director does not act in "good faith." The *Disney* decision highlights and cautions that directors can be held personally liable for not acting in good faith.

The Court articulates what it describes as three of the "most salient," albeit non-exclusive, examples of the failure to act in good faith:

- where a fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation;
- where the fiduciary acts with the intent to violate applicable positive law; or
- where the fiduciary intentionally fails to act in the face of a known duty to act.

The Court notes, as another example of the inadequacy of the traditional fiduciary duties of care and loyalty to protect shareholders, Section 144(a) of the DGCL, which provides that a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: (i) the approving directors were aware of the conflict inherent in the transaction; (ii) the approving directors were aware of all facts material to the transaction; and (iii) the approving directors acted in good faith. The third prong of good faith is necessary to prevent directors who were aware of the conflict and material facts from approving a transaction that is not in the corporation's best interests

because they were not acting in a manner to benefit the corporation but instead to reward a colleague or interested person.

After delineating the aspects of the duty of good faith, Chancellor Chandler concluded that Michael Eisner, Disney's then CEO and Chairman of the Board, and the other current and former Disney Board members, while not exemplifying best corporate practices, did not breach his or her fiduciary duty of care or act in bad faith in connection with the hiring and firing of Michael Ovitz (and the sizable monetary obligations created by the Board's conduct). With respect to Mr. Eisner, the Court found that Mr. Eisner made an informed decision to terminate Mr. Ovitz without cause based on the advice of counsel. After weighing the potential alternatives and costs, Mr. Eisner did what he thought was best for Disney and terminated Mr. Ovitz without cause and, according to the Chancellor, acted in good faith. Chancellor Chandler criticizes Mr. Eisner for his "imperial" management of Disney and his failure to keep the Board of Directors informed. In a footnote, Chancellor Chandler states that it is in this type of situation that the duty of good faith may be important since "the fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests. . . . Good faith may serve to fill this gap and ensure that the persons entrusted *by shareholders* to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect."

With respect to the remainder of the Board, the Court held that, even though the Board was armed with little knowledge, the directors "did not intentionally shirk or ignore their duty, but acted in good faith, believing that they were acting in the best interests of the corporation." Thus, while the Court made it clear that breaches of the duty of good faith are actionable, the conduct of the Disney Board did not reach that level.

The Business Judgment Rule

The Court restates the business judgment rule, which provides that if corporate fiduciaries act in an informed manner and are disinterested and independent, a court will not second guess their business decisions, even if that decision is determined (with the benefit of hindsight) to have been a bad one. The Court confirms that the business judgment rule allows directors to take value-enhancing risks in order to maximize shareholder value without fear of later judicial retribution for making an incorrect, money-losing decision. Nonetheless, the *Disney* opinion's extended discussion of "good faith" makes clear that each director must deliberate in a diligent and conscientious manner on the subject matter at hand, and that directors' motives and the underlying process through which a Board reached a decision will be subject to careful scrutiny in the event of a dispute.

The Disney directors were entitled to the protections of the business judgment rule because, although the Board's process was flawed, given the relative size and importance of the transaction, it was sufficient. The Court went to great lengths to distinguish *Disney* from *Smith v. Van Gorkom*, one infamous instance in which a court found that corporate fiduciaries breached their fiduciary duty of care. In *Van Gorkom*, the Board considered the ultimate sale of the company, for less than two hours with no advance notice, a lack of formal documentation such as

a fairness opinion, and misleading and uninformed presentations given by two executive officers. By way of contrast, in *Disney*, while hiring Ovitz was an expensive proposition that ultimately obligated Disney to pay Ovitz well over $100 million, given Disney's size it was not a material transaction and was quite different from a decision that would end a company's existence. Despite the Court's misgivings regarding the process that the defendants employed, the opinion emphasizes that directors must follow a process that enables them to act in an informed manner. The extent of the particular process that corporate fiduciaries must utilize to maintain the protections of the business judgment rule varies depending on the size, nature and materiality of the transaction at issue.

* * * * * * * * * * * * * * *

Ultimately, the Disney opinion reinforces that directors should strive to meet high standards of corporate governance. The existence and scope of the duty of good faith has been the subject of recent topical debate and very well may generate further guidance in the near future by the Chancery Court or the Delaware Supreme Court. The Disney opinion serves as a cautionary signal that while the business judgment rule is a well-established doctrine of Delaware law, a director must be mindful that he will be held personally accountable for failing to act in "good faith." Each director must be diligent and conscientious as to what he or she is being asked (or not asked) to consider and approve. The law is clear that a Board is permitted to make informed business decisions and be wrong, without worrying about personal liability. The Disney opinion and the Court's discussion of "good faith" also make clear that how a director came to that decision, including the Board's process and motives, could impact the personal liability of each director.

* * * * * * * * * * * * * * *

If you have any questions concerning this memorandum, please call or email Steven A. Seidman (212-728-8763, sseidman@willkie.com), John S. D'Alimonte (212-728-8212, jd'alimonte@willkie.com), Steven J. Gartner (212-728-8222, sgartner@willkie.com), Tariq Mundiya (212-728-8565, tmundiya@willkie.com), Laura L. Delanoy (212-728-8662, ldelanoy@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

September 6, 2005

Copyright © 2005 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.